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No. 01-1418

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITIONERS' BRIEF

HARRY G. GORDON
GORDON LAW OFFICES
400 West Market Street
Greensboro, NC 27401
(336) 275-9910

SETH P. WAXMAN
Counsel of Record
PHILIP D. ANKER
CRAIG GOLDBLATT
ANNE HARKAVY
KATE HUTCHINS
WILMER, CUTLER & PICKERING
2445 M Street, N.W.
Washington, D.C. 20037
(202) 663-6000

Counsel for Petitioners

QUESTION PRESENTED

Whether a debt that would otherwise be nondischargeable under Section 523(a) of the Bankruptcy Code (such as a debt for money obtained by means of fraud) becomes dischargeable if the parties enter into a settlement agreement under which the amount of the debt is liquidated.

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PETITIONERS' BRIEF

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit (Pet. App. 1a-15a) is reported at 283 F.3d 230 (4th Cir. 2002). The opinions of the district court (Pet. App. 17a-25a) and the bankruptcy court (Pet. App. 29a-36a) are not reported.

JURISDICTION

The court of appeals entered judgment on March 8, 2002. Petitioners A. Elliott Archer and Carol A. Archer filed a timely petition for a writ of certiorari on March 22, 2002. This Court granted that petition on June 24, 2002. Jurisdiction is proper in this Court pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

11 U.S.C. § 523(a) is reprinted at Pet. App. 43a-48a. Title 11 of the United States Code is referred to herein as the Bankruptcy Code.

STATEMENT

1. Statutory Background.

a. *Nondischargeable debt.* Bankruptcy is intended to provide "honest but unfortunate" debtors with a fresh start. *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998). A "central purpose of the [Bankruptcy] Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (citations and internal quotation omitted). The statutory discharge is the central mechanism available under the Bankruptcy Code to effectuate the fresh start policy for either the individual or reorganized corporate debtor.

Under this mechanism, debts that were due as of the filing of the bankruptcy petition are typically "discharged" at the end of the bankruptcy. *See, e.g.*, 11 U.S.C. §§ 727 (chapter 7 discharge), 1141 (chapter 11 discharge), 1328(b) (chapter 13 discharge). The discharge "operates as an injunction" against any action a creditor might take to collect the discharged debt. 11 U.S.C. § 524.

In the context of individual debtor bankruptcies, in order to limit the discharge to the "honest but unfortunate debtor," *see, e.g.*, *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934), the Bankruptcy Code sets forth certain exceptions to the discharge. As specifically applicable here, the Bankruptcy Code excepts from the discharge debts for money obtained by fraud. *See* 11 U.S.C. § 523(a)(2)(A) (the bankruptcy discharge "does not discharge an individual debtor from any

debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud"); *see also* 11 U.S.C. § 523(a)(4).

If the bankruptcy court determines that a debt is nondischargeable, the creditor may continue its attempts to collect on the debt even after the close of the bankruptcy case. Congress concluded that "the creditors' interest in recovering full payment of debts in these categories outweighed the debtors' interest in a complete fresh start." *Grogan*, 498 U.S. at 287. Reflecting the longstanding view that the fresh start is limited to the "honest but unfortunate" debtor, many (though not all) of the categories of nondischargeability relate to fraudulent, tortious or other wrongful behavior by debtors.

Specifically, in addition to the fraud exception set forth in Section 523(a)(2), the Code contains 17 other categories of nondischargeable debts. These categories include, *inter alia*, debts: for alimony, maintenance or child support (523(a)(5)); for willful or malicious injury (523(a)(6)); for death or personal injury caused by operation of a motor vehicle while intoxicated (523(a)(9)); and as provided in federal criminal restitution orders (523(a)(13)).

b. *Procedures for showing nondischargeability.* The Bankruptcy Code defines "debt" broadly, to include any liability on a "claim." 11 U.S.C. § 101(12). A "claim" can be, among other things: (a) an unliquidated and disputed right to payment; (b) a right to payment that has been reduced to a judgment after litigation; or (c) a right to payment under the terms of a settlement agreement, *id.* § 101(5). A "debt" can take any of these, or many other, forms.

When a debt is both "unliquidated" and "disputed," a creditor who contends that the debt is nondischargeable must show two things. *First*, the creditor must prove that "by rules of state law" it is entitled to payment (in bankruptcy parlance, that the claim is "allowed"). *See id.* §§ 501, 502 (set-

ting forth procedures for filing "proofs of claims" and resolving objections thereto); *Grogan*, 498 U.S. at 283 (describing "the standard of proof that a creditor must satisfy in order to establish a valid claim against a bankrupt estate"). *Second*, through an "adversary proceeding" to determine nondischargeability, the creditor must prove that the debt falls within one of the categories of nondischargeability set forth in Section 523(a) of the Bankruptcy Code. *See* 4 Lawrence B. King et al., *Collier on Bankruptcy* ¶ 523.06, at 523-21 to 523-22 (15th rev. ed. 2002). Only the second demonstration—that the debt is nondischargeable—requires the creditor to initiate an adversary proceeding by filing a complaint in bankruptcy court. *See* Fed. R. Bankr. P. 4007, 7001-7087.[1]

If the debt takes the form of a judgment entered after a matter has been litigated, either party may invoke principles of collateral estoppel, in the adversary proceeding, to establish that the debt either does or does not fit within a category of nondischargeability set out in Section 523(a). For example, if the judgment entailed proof of fraud, the debtor will be estopped from denying, in the nondischargeability action, that the underlying debt was for money obtained by fraud. *Grogan*, 498 U.S. at 284. Collateral estoppel could also run in favor of the debtor, if a claim for fraud was previously litigated and judgment entered in the debtor's favor.

If the judgment is silent on whether the underlying claim arose from fraud, the creditor would be required to prove, in the nondischargeability proceeding, that the debt is traceable to fraud. Principles of res judicata do not constrain the creditor in this proof. *Brown v. Felsen*, 442 U.S. 127, 135 (1979).

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[1] The bankruptcy court has exclusive jurisdiction over determinations of nondischargeability for certain categories of debt (those set forth in Section 523(a)(2), (4), (6) and (15)). 11 U.S.C. § 523(c)(1); *Brown v. Felsen*, 442 U.S. 127, 135-36 (1979). For other categories of debt, jurisdiction may be exercised either by the bankruptcy court or any other state or federal court of competent jurisdiction. 4 Lawrence B. King et al., *Collier on Bankruptcy* ¶ 523.03, at 523-17 (15th rev. ed. 2002).

To the contrary, the creditor may introduce evidence relating to the underlying debt itself in order to demonstrate that the debt is in fact nondischargeable. *See id.*

The question presented in this case is whether the same principles should apply in cases in which the litigation ended in a settlement.

2. Factual Background And Proceedings Below.

a. According to the nondischargeability complaint filed in bankruptcy court (J.A. 86-90),[2] Leonard L. Warner and Respondent Arlene Warner bought a light manufacturing company for $250,000. (J.A. 47.) They then altered the company's financial records so that the financial statements would suggest that the company was very profitable (making more than $360,000 per year in profits), when in fact it was losing money. (J.A. 36-47.) The Warners then offered the company for resale for $1.24 million. Six months after buying the company, in May 1992, the Warners resold it to a corporation formed by Petitioners A. Elliott and Carol Archer. Based on the falsified financial records as well as other false statements made to them by the Warners, stating that the underlying business was a profitable one, the Archers

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[2] The nondischargeability complaint incorporates the allegations in an amended complaint previously filed in the state court fraud action, J.A. 34-60. As set forth below, *infra* at 8, the bankruptcy court, pursuant to Fed. R. Bankr. P. 7016 and Fed. R. Civ. P. 16(c), severed the question whether the settlement of the state court fraud suit barred the nondischargeability action from the question whether the underlying allegations of fraud were true. (J.A. 129-130.) Having found in favor of Respondent on the affirmative defense that the settlement barred the nondischargeability action, the bankruptcy court did not address the allegations of fraud. For purposes of appeal, those allegations must therefore be taken as true. *Cf. Swierkiewicz v. Sorema*, 534 U.S. 506 (2002) (assuming factual allegations to be true on reviewing dismissal of complaint).

agreed to pay $610,000 for the assets of the company. (*Id.*; Pet. App. 30a.)[3]

Upon taking possession of the assets, the Archers discovered that the financial statements provided to them by the Warners, and other representations the Warners made in connection with the sale, were materially false, and that the business was in fact losing substantial sums of money. (J.A. 36-47.) The Archers accordingly brought suit in late 1992 against Leonard Warner in state court in North Carolina asserting various claims, including common law fraud. On September 20, 1993, a grand jury indicted Leonard Warner for "misrepresent[ing] the financial condition of Greensboro Awning Company, Greensboro Fence Company and A&A Fence Company in negotiating for the sale of these companies to Archer." (J.A. 32-33.) Arlene Warner was added as a defendant in the civil action in 1994. (J.A. 34-60.)

After discovery, the parties (on the eve of trial) entered into a settlement agreement on May 11, 1995, under which the Archers would receive $300,000, consisting of a $200,000 cash payment and a promissory note for $100,000 payable in two installments over a year.[4] In connection with the settlement, the parties agreed to execute a settlement agreement (J.A. 61-66), a general release (J.A. 67-69), a mutual release (J.A. 70-72), and the promissory note (J.A. 73-76), secured by a deed of trust. In the settlement agreement, the Archers agreed "to inform the District Attorney that they

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[3] The Archers also paid a $70,000 consulting fee to Leonard Warner, and $5,000 in consideration for a non-compete agreement from Leonard Warner, bringing the total consideration in the transaction to $685,000. (Pet. App. 30a.)

[4] Although the promissory note was secured by two deeds of trust, one on a home that the Warners owned and one on real property owned by Hosiery Industries, Inc., another corporation owned by the Warners, all of those assets were subject to prior liens, and therefore did not adequately secure the $100,000 in indebtedness. (*See* J.A. 75.)

have been compensated for their loss." (J.A. 62.) The district attorney accordingly dismissed the indictment. (J.A. 77-79.) The settlement agreement also provided that the releases being executed would not release any claims "as to amounts set forth in this Settlement Agreement." (J.A. 63.)

The general release stated that, in consideration for the payment of $300,000, the Archers "release and forever discharge [the Warners] from any and every right, claim or demand which [the Archers] now have or might otherwise hereafter have against [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of [the state court litigation]." (J.A. 67.) Consistent with the settlement agreement, the general release expressly excluded from the release "obligations under a Note and deeds of trust executed contemporaneously herewith." (*Id.*) No party "admit[ted] liability or wrongdoing whatsoever in signing this agreement." (*Id.*) A separate document, entitled a "mutual release," was executed contemporaneously, and included similar release language. (J.A. 70.)

The Warners defaulted on the first payment due on the promissory note, which was due on November 11, 1995. (J.A. 87.) The Archers thereupon brought a collection suit in state court in North Carolina to recover on account of the debt due to them on the note, arising from the underlying fraud allegations. (J.A. 88.)

b. On February 6, 1996—while the state court collection action was pending and less than nine months after entering into the settlement under which the Warners wrote the promissory note—Leonard and Arlene Warner filed for relief under chapter 13 of the Bankruptcy Code. (Pet. App. 31a.) Their case was subsequently converted to chapter 7. (*Id.*) The Archers thereupon brought an adversary proceeding in the bankruptcy case against the Warners, seeking a determination that the debt was nondischargeable on the ground, inter *alia*, that it was for money obtained by fraud. 11 U.S.C.

§ 523(a)(2).[5] Leonard Warner did not contest the issue of dischargeability in bankruptcy court, which entered a consent judgment against him. (Pet. App. 39a-41a.)

Arlene Warner did contest dischargeability, asserting that the underlying debt was not obtained on account of any fraud on her part, and that the settlement of the fraud claim barred the Archers from relying on any underlying acts of fraud in support of the claim of nondischargeability. (J.A. 91-94.) The bankruptcy court bifurcated the proceedings, first addressing the "affirmative defense" that the general release given in connection with the settlement of the state court fraud suit barred the nondischargeability action in the bankruptcy court. (J.A. 129-130.)

Following decisions of the Seventh and Ninth Circuits, the bankruptcy court concluded that the release barred the Archers from attempting to prove nondischargeability. "By including in the release future claims, the court concludes that the plaintiffs effectively released and extinguished the dischargeability claim which they now seek to assert against the defendant." (Pet. App. 35a.)[6]

The district court affirmed, agreeing that inquiry into the nature of the underlying debt was prohibited because that debt had been settled and a general release signed. (Pet. App. 20a-25a.)

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5 The Archers subsequently sought to amend their complaint to allege that the settlement agreement was procured by means of fraud. (J.A. 95-108.) The bankruptcy court denied the motion for leave to amend the complaint on grounds of procedural default. (J.A. 109.) While the Archers do not challenge that determination in this Court, the surrounding circumstances are set forth in the Affidavit of Harry G. Gordon at J.A. 124-126.

6 Because a consent judgment had been entered against Leonard Warner, the bankruptcy court's final disposition of the claims against Arlene Warner represented a final judgment (Pet. App. 39a), appealable to the district court under 28 U.S.C. § 158(a)(1).

c. A divided panel of the court of appeals affirmed. The panel majority ruled that, by settling, the Archers relinquished not only their right to sue on the underlying fraud, but also compromised their ability to collect the amount promised in the settlement. In the court's view, the settlement effected a "novation" that converted the nondischargeable fraud claim into a dischargeable contract claim. (Pet. App. 8a-10a.) The court believed that its approach was necessary to promote settlement: "Under this theory, parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy. Otherwise the incentive to settle is gone." (Pet. App. 8a.)

Judge Traxler dissented, urging that the contrary approach taken by the D.C. and Eleventh Circuits better serves the underlying congressional judgment that certain debts should not be discharged in bankruptcy. He explained that "'a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress . . . , merely by altering the *form* of his debt through a settlement agreement.'" (Pet. App. 12a (quoting *United States v. Spicer*, 57 F.3d 1152, 1156 (D.C. Cir. 1995) (alteration in original).) "[I]f, as the Supreme Court has declared, 'the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt' . . . then I see no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry." (Pet. App. 15a (quoting *Brown*, 442 U.S. at 138).)

SUMMARY OF ARGUMENT

An animating purpose of federal bankruptcy law is to provide honest but unfortunate debtors with a fresh start. Accordingly, at the end of a debtor's bankruptcy case, the debtor's dischargeable prepetition debts are discharged, and

creditors are thereby enjoined from taking any action to collect such debts. *See* 11 U.S.C. § 524.

The "fresh start" is available only to "honest but unfortunate debtors," not those whose debts arise, for instance, on account of fraud or embezzlement. Section 523(a) of the Bankruptcy Code accordingly sets forth 18 exceptions to the discharge. A creditor who contends that the debt owed to him or her is nondischargeable because it falls within one of the categories specified in Section 523(a) may bring an action in the bankruptcy court seeking a declaration to that effect.

The Fourth Circuit below held that if the debt is reduced to a settlement agreement, the creditor is barred from asserting that it is nondischargeable. The court's rationale was that the settlement effected a "novation," under which the debt reflected in the settlement agreement replaced the debt arising on account of the alleged acts of fraud.

While it may be true that a settlement effects a novation, it does not follow that the "new" debt is dischargeable. To the contrary, this Court's decision in *Brown*, 442 U.S. 127, makes clear that the bankruptcy court must nevertheless undertake an inquiry into whether the "new" debt is traceable to fraud.

Under ordinary principles of res judicata, once a judgment is entered, the plaintiff is barred from suing on the underlying claim, and is permitted only to bring suit to enforce the judgment. The judgment effects a "novation" no differently from the way in which a settlement does. That fact notwithstanding, *Brown* held that in a nondischargeability action, the bankruptcy court should "weigh all the evidence" to determine whether the debt "aris[es] out of conduct specified [in Section 523(a)], because "Congress intended the fullest possible inquiry" into whether the underlying source of the debt was an act of fraud." *Brown*, 442 U.S. at 138.

The fundamental holding of *Brown* is that, despite the finality afforded to judgments, the bankruptcy court should nevertheless undertake a fresh examination into the question whether the underlying debt is nondischargeable. That holding accords with this Court's conclusions that the plain meaning of the Bankruptcy Code—which provides that "any debt" for money obtained by fraud is nondischargeable—demonstrates an intent to exclude from the discharge any debt "resulting from" or "traceable to" fraud, in order to effectuate the policy of limiting the discharge to the honest but unfortunate debtor. *Cohen v. de la Cruz*, 523 U.S. 213, 218 (1998). The same principle applies with equal force to debts reduced to settlements.

The court of appeals believed that its approach was necessary to promote settlement. While it is true that a rule that would render dischargeable otherwise nondischargeable debt would give the *debtor* an added incentive to settle, it would have a simultaneous and opposite effect on the creditor's incentives. Insofar as the rule would encourage settlements at all, then, it would do so in circumstances in which an unwitting creditor was unaware of the debtor's financial condition or the effect the settlement would have on a claim of nondischargeability. There is no reason to read Section 523(a) of the Bankruptcy Code to create such a trap for the unwary.

There is certainly nothing in the Archers' settlement agreement itself, a standard settlement with a general release, that requires this result. The settlement agreement here, like any standard settlement, preserves all rights the creditor might have to enforce his rights to collect the amount the debtor promised to pay under that settlement. The assertion that the debt is nondischargeable is no more than an effort to collect that amount.

In any event, even if the parties had intended to resolve, at the time the state court suit was settled, the question of dischargeability, there is serious question as to whether such an agreement would be unenforceable as inconsistent with—

and therefore preempted by—fundamental principles of bankruptcy law. In the context of bankruptcy, an agreement between the debtor and creditor regarding the settlement of a dispute affects not only the debtor and creditor, but also all third-party creditors, whose claims will be paid out of the same limited pool of the debtor's assets.

The discharge confers a personal benefit on an individual debtor. Thus, a rational debtor would always be willing to promise to pay more to a creditor in connection with a settlement that rendered dischargeable an otherwise nondischargeable debt than the debtor would offer to settle the same dispute in the absence of such a feature. In the event of bankruptcy, then, the creditor would enter the bankruptcy case with a proportionately larger claim against the assets available to pay unsecured creditors, thereby diluting the claim of other unsecured creditors. As a result, the debtor benefits, and other unsecured creditors are harmed.

The Bankruptcy Code contains specific provisions that serve to guard against this risk. Specifically, once a bankruptcy case has begun, any disposition of the debtor's property, including any settlement or compromise of any dispute, requires approval of the bankruptcy court, on notice to creditors. *See* 11 U.S.C. § 363; Fed. R. Bankr. P. 9019. Enforcing a prepetition agreement addressing questions of dischargeability—which arise only in the bankruptcy context—would permit an end run around these protections that the Bankruptcy Code affords all creditors.

Because the debtor benefits from the discharge, but does not suffer any corresponding detriment by these actions that dilute the recovery of other creditors, permitting the parties to negotiate, prepetition, over questions of nondischargeability permits the debtor to "externalize" the costs while "internalizing" the benefits. The Bankruptcy Code should not be construed to permit a debtor, in effect, to purchase a discharge of otherwise nondischargeable debt using money that properly belongs to other creditors.

ARGUMENT

I. THE FORM OF A DEBT IS IRRELEVANT TO THE QUESTION OF DISCHARGEABILITY.

Under the Bankruptcy Code, "any debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud" is exempt from discharge. 11 U.S.C. § 523(a)(2)(A). This Court has repeatedly stressed the breadth of this exception, explaining that it encompasses all debt "resulting from" or "traceable to" fraud. *Cohen v. de la Cruz*, 523 U.S. 213, 218 (1998) (quoting *Field v. Mans*, 516 U.S. 59, 61, 64 (1995)).

Thus, in *Cohen*, the Court held that the exemption includes an entire treble damages award rendered on account of fraud, and is not limited to the debtor's ill-gotten gains. The Court explained, by using the broad phrase "*any* debt," Congress intended to except from discharge any "debt as a result of," "debt with respect to," "debt by reason of," "debt arising from," or "debt on account of," an act of fraud. *Cohen*, 523 U.S. at 220. In short, the issue boils down to a basic question of causation—if a causal connection can be drawn between the debt and an act of fraud, the debt is nondischargeable.

This conclusion follows directly from the text of the Bankruptcy Code. A "debt," for the purposes of bankruptcy law, can take any number of different forms. The Bankruptcy Code defines a "debt" to mean any "liability on a claim," 11 U.S.C. § 101(12), and in turn defines the term "claim" to include a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured," *id.* § 101(5).[7]

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[7] The intentional breadth of the definition of "debt," and thus the significance of the fact that "any debt" traceable to fraud is nondischargeable, is confirmed by the history of Section 523, whose antecedent is Sec-

In the language of the Bankruptcy Code, then, when a creditor who was a victim of fraud settles the fraud claim with the tortfeasor, the form of the debt is converted from being "unliquidated" and "disputed," to being "liquidated" and "undisputed." Although the form of the debt has changed, there can be no question that it remains a debt that is "traceable to" fraud. *Cohen*, 523 U.S. at 218. As the D.C. Circuit explained, while a "settlement agreement alters the legal form of [an] obligation, it does not transmogrify its essential nature so as to immunize it from the command of § 523(a)(2)(A) that debt for money or property obtained by fraud is not dischargeable in bankruptcy." *United States v. Spicer*, 57 F.3d 1152, 1157 (D.C. Cir. 1995) (Wald, J.).

This result is unsurprising, because a debtor who defrauds a creditor and then settles is no more honest than a debtor who defrauds a creditor and then loses at trial. To deny the creditor who settles the chance to prove that his debt arose from fraud would thus be at odds with Congress's judgment that only the "honest but unfortunate" debtor deserves a fresh start. *Cohen*, 523 U.S. at 217 (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)).

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tion 17 of the Bankruptcy Act of 1898. As originally enacted, the Bankruptcy Act provided that only "judgments" for fraud would be excepted from the discharge. 30 Stat. 550. This provision was amended in 1903 to provide that all "liabilities" for fraud would be excepted from the discharge, regardless of whether those "liabilities" were in the form of a "judgment." *See also Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 562 (1990) ("Congress defined 'debt' broadly and took care to except particular debts from discharge where policy considerations so warranted."); H.R. Rep. No. 95-595, at 309 (1977) (definition of "claim" is "broadest possible").

II. SETTLEMENT OF A CLAIM DOES NOT BAR A CREDITOR FROM PROVING THAT THE OBLIGATION TO PAY ON THE SETTLEMENT IS NONDISCHARGEABLE.

The parties to a matter that has been litigated to judgment may invoke collateral estoppel to show that the debt is, or is not, nondischargeable. *Grogan*, 498 U.S. at 284-85. The collateral estoppel doctrine is not available, of course, in a case that has been settled.[8] Rather, the creditor is required to prove that his debt arose from fraud. There is nothing in the nature of a settlement, however, that is inconsistent with allowing a creditor to present such proof. To the contrary, it follows from this Court's decision in *Brown* that a creditor should be allowed to establish the connection between the debt and an underlying act of fraud.

A. In *Brown*, the owner of a car dealership was alleged to have induced a third-party, by making false statements, to guarantee a bank loan. When the dealership failed to pay, the bank brought a collection action in state court against the dealership, its owner and the guarantor. The guarantor cross-claimed against the dealership owner, claiming that the guarantee was fraudulently obtained. *Brown*, 442 U.S. at 128.

The state court action ended in a settlement. In connection with that settlement, the state court entered a consent judgment, authorizing the bank to recover jointly and severally against the dealership owner and the guarantor and allowing the guarantor to recover against the dealership owner.

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[8] "To support preclusion at all, there must be a judgment in some form; a settlement agreement by itself is effective only as a contract." 18A Charles Alan Wright et al., *Federal Practice and Procedure* § 4443, at 255-56 (2d ed. 2002). Because collateral estoppel applies only to a matter that has been "actually litigated," settlements may be entitled to claim preclusive (res judicata) effect, but do not support issue preclusion (collateral estoppel). *See Arizona v. California*, 530 U.S. 392, 414 (2000); *United States v. International Building Co.*, 345 U.S. 502, 505-06 (1953).

Neither the judgment nor the stipulation indicated the cause of action on which the judgment was entered, or otherwise addressed whether acts of fraud were or were not committed. *Id.* The dealership owner failed to pay on the stipulated judgment, and shortly thereafter filed for bankruptcy. *Id.*

This Court rejected the argument that principles of res judicata barred the guarantor, in a nondischargeability proceeding, from proving facts that he could have established but did not in the underlying suit. *See id.* at 138. Rather, the Court held that it was incumbent on the bankruptcy court, as a matter of federal bankruptcy law, to "weigh all the evidence" to determine whether the debt arose out of fraud. "Congress intended the fullest possible inquiry" into that question. *Id.* As the Court explained, "the mere fact that a conscientious creditor has previously reduced his claim to judgment" did not "bar further inquiry into the true nature of the debt" or prevent the bankruptcy court from making "an accurate determination whether respondent in fact committed the deceit, fraud and malicious conversion which petitioner alleges." *Id.*[9] (*see also* J.A. 14a) (Traxler, J., dissenting) ("In deciding cases dealing with the fraud exceptions to dischargeability, courts should effectuate congressional policy objectives by conducting the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor.")).

B. The principal basis for the court of appeals' ruling in this case was that a settlement effects a "novation," by which it meant "the substitution of a contract claim for a tort claim through a settlement agreement . . . ." (Pet. App. 9a n.8.) But this characterization of the debt does not distin-

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[9] While *Brown* involved Section 17 of the Bankruptcy Act of 1898, the predecessor to Section 523(a) of the Bankruptcy Code, the *Brown* Court expressly noted that "[d]ischarge provisions substantially similar to § 17 of the Bankruptcy Act appear in § 523 of the new law." *Brown*, 442 U.S. at 129 n.1.

guish this case from *Brown*. To the contrary, precisely the same could have been said in *Brown*—that the judgment replaced the underlying claim of fraud. That fact notwithstanding, this Court held that the bankruptcy court should make a factual inquiry into whether the debt was traceable to fraud and thus, nondischargeable. The same is true here.

The consequence of a novation is simply that the creditor may no longer sue on the underlying fraud, but must sue on the note. *See Black's Law Dictionary* 1091 (7th ed. 1999) (defining "novation" to be the "act of substituting for an old obligation a new one that . . . replaces an existing obligation with a new obligation"). A judgment creditor is likewise barred from suing on the underlying claim, and may sue only to enforce the judgment. Thus, the fact of a "novation" does not distinguish a settlement from a judgment. Once a claim is litigated to judgment, the claim "is extinguished, and the judgment with new rights of enforcement thereof is substituted for the claim." *See* Restatement (Second) of Judgments § 17 (1982) cmt. a. A judgment therefore represents a "novation" in every sense.

Brown established that a bankruptcy court hearing a nondischargeability action should nevertheless seek to determine whether the "new" debt arising from the judgment can be traced to an act of fraud. There is no reason to treat a "novation" by settlement differently from a "novation" by judgment.[10] In both cases, the debtor owes a "debt" within

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[10] The leading bankruptcy treatise describes this as "the better view" in addressing Section 553 of the Bankruptcy Code. Under that provision, a creditor may offset amounts its owes to the debtor from amounts the debtor owes to it, provided that the obligations in both directions are characterized as prepetition debts. *See* 5 Lawrence B. King et al., *Collier on Bankruptcy* ¶ 553.03[1][ii], at 553-24 (15th rev. ed. 2002) (pointing to *Spicer*, *West*, and other lower court cases on nondischargeability in support of conclusion that "the better view is that a prepetition claim should not be transformed into a postpetition obligation simply because the parties settled rather than litigated").

the meaning of the Bankruptcy Code, and that debt is nondischargeable so long as it is "resulting from" or "traceable to" fraud. *Cohen*, 523 U.S. at 218.

C. Indeed, *Brown* itself involved a dispute that was settled. As the Court noted, the state court action "was settled by a stipulation" and the state court entered a "consent judgment." 442 U.S. at 128, 132.

While a consent judgment is entered by a court, it is, in substance, a settlement agreement. Consent judgments are "contractual in nature, and are, in effect, contracts or agreements of parties acknowledged in court and ordered to be recorded with the sanction of the court." 46 Am. Jur. 2d *Judgments* § 210, at 535 (1994); *see also id.* at 537 ("A consent decree is essentially a settlement agreement subject to continued judicial policing.") And, like an out-of-court settlement, a consent judgment "do[es] not result from a judicial determination of the rights of the parties or the merits of the case." *Id.* at 535. There is thus no plausible basis for distinguishing between these forms of settlement in determining whether a nondischargeability action may proceed. *See In re Francis*, 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998) (creditor should not be "barred from the opportunity to prove the true nature of the debt just because the parties elected to keep their settlement agreement private and not to burden the state court with an unnecessary consent judgment").

For purposes of determining whether a debt is dischargeable, there is no reason to treat an obligation that is reflected in a settlement agreement any differently from an obligation that has been reduced to judgment. Indeed, the central purpose of a settlement agreement containing a release is to create the same finality afforded to a final judgment by virtue of the doctrine of res judicata.

In general, "an undisputed and valid settlement of a controversy by agreement of the parties has the same force and effect as though a judgment had been entered in an action on

the claim, and irrevocably fixes the rights and liabilities of the parties thereto in relation to the subject matter dealt with." 15A C.J.S. *Compromise & Settlement* § 26 (1967).

Accordingly, courts generally grant settlement agreements the same claim preclusive (res judicata) force as are given to judgments. In *Oglesby v. Attrill*, 105 U.S. 605 (1881), for example, this Court enforced a compromise agreement releasing fraud claims, stating that the "compromise stands, therefore, *as a judgment*, making a settlement of the very matters now set up as grounds of complaint in the petition . . . ." *Id.* at 611 (emphasis added).[11]

There is therefore no basis for drawing a decisive distinction, as the court of appeals has, between a settlement agreement reflected in a consent judgment, and a settlement agreement whose terms are documented in a private contract. In either case, questions relating to the dischargeability of the debt remain "the type of question Congress intended that the bankruptcy court would resolve" after "the fullest possible inquiry." *Brown*, 442 U.S. at 138.

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[11] *See Thomas v. Louisiana*, 534 F.2d 613, 615 (5th Cir. 1976) ("Settlement agreements . . . [w]hen fairly arrived at and properly entered into . . . are generally viewed as binding, final, and as conclusive of rights as a judgment"); *A.D. Juilliard & Co. v. Johnson*, 259 F.2d 837, 844 (2d Cir. 1958) ("The effect of a compromise and settlement effected by parties competent to contract is that of a judgment which can only be set aside in a direct proceeding."); *Crisp County v. S.J. Groves & Sons Co.*, 73 F.2d 327, 329 (5th Cir. 1934) ("This settlement was . . . not different in this respect from a judgment on it, if there had been litigation instead of a compromise."). *See also Arizona v. California*, 530 U.S. 392, 414 (2000) ("the settlement indeed had, and was intended to have, claim-preclusive effect") (emphasis omitted); *Hoxworth v. Blinder*, 74 F.3d 205, 208 (10th Cir. 1996) ("Generally, court-approved settlements receive the same *res judicata* effect as litigated judgments.").

III. NOTHING ABOUT THE ARCHERS' SETTLEMENT IN PARTICULAR SUGGESTS AN INTENT TO WAIVE THEIR RIGHT TO ESTABLISH NONDISCHARGEABILITY.

A. As just explained, there is nothing about settlement in general that prevents a creditor from attempting to establish that the underlying debt arose from fraud. Nor is there anything in the Archers' settlement in particular that would suggest an intent to waive the right to establish the nondischargeability of their debt.

1. The general release that the Archers signed stated that, in consideration for the payment of $300,000, they "release and forever discharge [the Warners] from any and every right, claim or demand which [the Archers] now have or might otherwise hereafter have against [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of [the state court litigation]." (J.A. 67.) The agreement expressly excluded from the release, however, "obligations under a Note and deeds of trust executed contemporaneously herewith." (*Id.*; *see also* J.A. 63 ("All parties to the litigation agree to execute releases to any and all claims any party may have or may have had against the other in any way arising out of this litigation, except as to amounts set forth in this Settlement Agreement.").)[12]

Thus, far from impairing their right to collect on the note, the settlement agreement that the Archers signed expressly preserved that right. Indeed, even without this express reservation, a settlement agreement releasing an underlying claim in exchange for a promise to pay an agreed

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12 A separate document, entitled a "mutual release," was executed contemporaneously, and inciuded similar release language. (J.A. 70.) The general release (J.A. 67) and settlement agreement (J.A. 62) expressly note that the underlying claims arise out of allegations of fraud and other intentional torts.

amount certainly does not to waive the right to collect the amount promised under that agreement.

2. Because the nondischargeability action was brought solely in order to enforce the agreement to pay that amount, the agreement does not waive the right to show nondischargeability. As this Court explained in *Brown*, a nondischargeability action is not an affirmative "claim" against the debtor at all. The creditor "does not assert a new ground for recovery." *Brown*, 442 U.S. at 133. Rather, the creditor "is attempting to meet . . . the new defense of bankruptcy which [the debtor] has interposed between [the creditor] and the sum determined to be due to him." *Id.*[13]

This case is illustrative. After the Warners defaulted on the promissory note, the Archers brought a collection action in order to enforce their right to recover the $100,000 due to them. That action was subject to the automatic stay in bankruptcy, and the Archers were thus precluded from taking any action to prosecute their collection suit during the pendency of the bankruptcy case. *See* 11 U.S.C. § 362(a). While the automatic stay ends at the end of the bankruptcy case, *see id.* § 362(c)(2), a debtor thereafter may assert the discharge as a defense to the collection action, *see id.* § 524.

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13 Indeed, until 1970, questions of dischargeability of debt were commonly heard in state court as a defense to an action to collect on that debt. *See, e.g.*, *Local Loan Co. v. Hunt*, 292 U.S. 234, 241 (1934) (stating that state court "was authorized in the law action to afford relief the equivalent of that which respondent now seeks in equity"). "Before 1970, . . . [bankruptcy courts] left the dischargeability under § 17 of a particular debt to the court in which the creditor sued, after bankruptcy, to enforce his particular judgment." *Brown*, 442 U.S. at 133. "The 1970 amendments took jurisdiction over certain dischargeability exceptions, including the exceptions for fraud, away from the state courts and vested jurisdiction exclusively in the bankruptcy courts." *Grogan*, 498 U.S. at 284 n.10; *see* Pub. L. No. 91-467, §§ 5-7, 84 Stat. 992; H.R. Rep. No. 91-1502 (1970); S. Rep. No. 91-1173 (1970). Accordingly, bankruptcy courts are the proper forum for resolving this "new defense of bankruptcy." *Brown*, 442 U.S. at 133.

Thus, even if it were not expressly excluded from the release because it is an action to collect on the note received under the settlement, the Archers' nondischargeability action still would not be released because it is not a "right, claim or demand" within the meaning of the settlement agreement. The Archers do not assert any new ground for recovery or seek to recover any additional amount beyond enforcing their rights under the settlement agreement and promissory note. Rather, the nondischargeability action is a response to the "new defense of bankruptcy," *Brown*, 442 U.S. at 139, that would otherwise bar their state court collection suit brought on the promissory note.

B. The court of appeals nonetheless believed that, to encourage settlement, it was justified in treating this agreement as waiving the right to show nondischargeability. According to the court of appeals, "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract. Otherwise, the incentive to settle is gone." (Pet. App. 8a.)

While it is true that *debtors* who may discharge their debts when they settle otherwise nondischargeable claims have an additional incentive to settle before trial, creditors are simultaneously and equally discouraged from settling. Because the consent of both parties is of course required for a matter to settle, there is no reason at all to believe that a legal rule that made settlement more attractive to a debtor, but (to the same extent) less attractive to creditors, would increase the likelihood of settlement. To the contrary, as in *Brown*, the rule applied by the court of appeals would require a creditor to litigate the issue of fraud "to the hilt in order to protect himself against the mere possibility that a debtor might take bankruptcy in the future." *Brown*, 442 U.S. at 135.

The only circumstances in which the rule applied by the Fourth Circuit below would change the likelihood of settlement, then, would be those in which a plaintiff is unaware that the defendant is likely to file for bankruptcy, or is not

alert to the legal effect of entering into a settlement agreement that is silent on the question of nondischargeability. In those cases, a plaintiff who enters into a standard settlement agreement will have unwittingly agreed to have an otherwise nondischargeable debt converted into a claim that will be discharged in bankruptcy. Those defendants who are likely to file for bankruptcy—and who of course have greater access to information about their own financial condition than their creditors—would therefore be able to circumvent the effect of Section 523(a) of the Bankruptcy Code by settling claims for otherwise nondischargeable debt with creditors who are unaware of those consequences.

There is no warrant to construe the Bankruptcy Code—which seeks to promote fairness among creditors—to create such a trap for the unwary. Indeed, in light of the fact that many of Section 523(a)'s provisions are intended for the benefit of creditors who may be most in need of protection (such as those who have been victims of fraud, 11 U.S.C. § 523(a)(2) & (a)(4); victims of "willful and malicious injury by the debtor," *id.* § 523(a)(6); and creditors who are owed awards of alimony, maintenance or child support, *id.* § 523(a)(5)), it would be particularly inappropriate to adopt a construction of the statute that effectively creates an incentive for an unscrupulous debtor to take advantage of an unwitting creditor.[14]

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[14] The trap for the unwary created by the court of appeals' construction of Section 523(a) is further demonstrated by the fact that an astute creditor would be able to take steps to protect itself, in negotiating a settlement agreement, to prevent the debt from being rendered dischargeable. For example, the settlement agreement might be structured such that the creditor grants a covenant not to sue on the underlying fraud claim, conditioned on timely payment of the agreed amount, rather than granting a release of the underlying claim. (*See also* Pet. App. 24a (district court opinion suggesting other such steps).) In any event, it is clear that the potential availability of such measures does not provide a basis for concluding, in their absence, that the settlement agreement renders the debt dischargeable. *See Brown*, 442 U.S. at 137 (rejecting the argument

IV. A PREPETITION WAIVER OF NONDISCHARGEABILITY PROTECTIONS SHOULD, IN ANY EVENT, BE DEEMED NONENFORCEABLE.

Even if the settlement agreement had purported to waive the Archers' right to establish the nondischargeability of their debt, there would be a serious question whether such a provision could be enforced. As explained below, a prepetition waiver of nondischargeability rights would impair the rights of other creditors, who are not parties to the agreement. Such a provision thus would be inconsistent with federal bankruptcy policy.

Bankruptcy law is a set of mandatory rules, designed to protect debtors and to provide for the fair treatment among creditors in circumstances in which the debtor's insolvency renders it impossible for all creditors to be paid in full.[15] Such rules frequently override the contractual agreements of debtors and creditors.

For example, in order to protect debtors, the Bankruptcy Code expressly provides that a postpetition agreement in which a debtor agrees to "reaffirm" a debt that would otherwise be dischargeable cannot be enforced unless specified

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that the debt was dischargeable because "petitioner could have avoided such a result and preserved his dischargeability contentions for bankruptcy court review by bargaining for a stipulation that § 17 issues were not resolved by the consent judgment").

[15] *See, e.g.*, Teresa A. Sullivan et al., *As We Forgive Our Debtors* 20 (1999) (describing the interest in "[p]rotecting each creditor from other creditors to achieve the fairest collective result" as one of bankruptcy's "most fundamental policies"); Peter J. Coleman, *Debtors and Creditors in America: Insolvency, Imprisonment for Debt, and Bankruptcy, 1607-1900*, at 269-70 (1999) (describing purpose of "American bankruptcy system" as being to "put all creditors on an equitable footing"); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 Yale L.J. 437, 468 (1992) ("The Code is thus designed not only to enhance the value of the failing business, but also to distribute that value among interested parties in specified ways.").

statutory requirements (intended to protect debtors) are met. 11 U.S.C. § 524(c); *see In re Bennett*, --- F.3d ---, 2002 WL 1784136, at *5-6 (9th Cir. Aug. 5, 2002). Courts and commentators agree that *pre*petition agreements that a debt will not be discharged cannot otherwise be enforced. *See, e.g., In re Kroen*, 280 B.R. 349, 352-53 (Bankr. D.N.J. 2002) (citing cases); *In re Cole*, 226 B.R. 647, 651-52 & nn.6 & 7 (B.A.P. 9th Cir. 1998) (collecting cases); *see also* Douglas G. Baird, *The Elements of Bankruptcy* 34-36 (rev. ed. 1993) (describing nonwaivability of fresh start); Thomas H. Jackson, *The Fresh-Start Policy In Bankruptcy Law*, 98 Harv. L. Rev. 1393 (1985) (same).

In addition to protecting debtors from overreaching by creditors, the Bankruptcy Code also promotes fair treatment among creditors. In a chapter 7 liquidation, assets that were property of the debtor are marshaled for the benefit of the creditors. In these circumstances the risk is necessarily present that the debtor and any single creditor might reach an agreement that serves each of their interests at the expense of other creditors. The laws of preference (*see* 11 U.S.C. § 547) and fraudulent conveyance (*see id.* § 548), for example, are intended to address these concerns. Thus, bankruptcy law and policy commonly require courts to invalidate such contractual agreements on the ground that they impermissibly burden the rights of absent third-party creditors.[16]

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[16] For example, a voluntary prepetition agreement between a debtor and a creditor to waive the protection of the automatic stay cannot be enforced in bankruptcy. *See, e.g., Ostano Commerzanstalt v. Telewide Sys., Inc.*, 790 F.2d 206, 207 (2d Cir. 1986) (per curiam) ("Since the purpose of the stay is to protect creditors as well as the debtor, the debtor may not waive the automatic stay."); *Association of St. Croix Condominium Owners v. St. Croix Hotel Corp.*, 682 F.2d 446, 448 (3d Cir. 1982) (stating in dictum that a debtor cannot waive stay protection); *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) (stating in dictum that advance agreements to waive the benefits of bankruptcy are void); *In re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996) (concluding that "the prebankruptcy waiver of the automatic stay of 11 U.S.C. § 362 is unenforce-

That is the concern that counsels against the enforcement of an agreement, made outside of bankruptcy, to provide that an otherwise nondischargeable debt would become dischargeable. The nondischargeability of a debt is a personal detriment to the debtor; it does not affect the rights of his or her creditors (other than the one to whom the debt is owed).

As the Seventh Circuit acknowledged, "[a] tort-feasor may well be inclined to pay an aggrieved party a larger sum in settlement if the settlement [renders the claim dischargeable]." *In re West*, 22 F.3d 775, 778 (7th Cir. 1994). But if the debtor "purchases" a discharge by paying a creditor more than he otherwise would pay to settle the claim, he secures a personal benefit by effectively diluting the claims that other creditors would otherwise have in the bankruptcy case. Such an agreement would permit a debtor to "externalize" the costs (by imposing them on other creditors) while "internalizing" the benefits (by enjoying the discharge after bankruptcy).[17] It thus should be deemed unenforceable as a matter of law as inconsistent with the Bankruptcy Code. *See In*

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able, per se"); *In re Jenkins Court Assocs.*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) (refusing to enforce a prepetition waiver of the automatic stay); *In re Sky Group Int'l Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) (same). Enforcing such an agreement "may prejudice [other creditors] by permitting the [creditor] to recover first from the debtor's assets. . . . The idea that parties can override bankruptcy law by contract . . . therefore conflicts with the traditional view that bankruptcy law is a form of public law, imposing mandatory rules to preserve distributional and rehabilitative interests." Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Tex. L. Rev. 515, 519-20 (1999).

17 *Cf.* G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 Bus. L. 499, 554 (2000) ("Because creditors have the right to exhaust the value of the debtor's nonexempt property through the enforcement of their claims, any further diminution in the value of the debtor's property arising from the debtor's risk taking will necessarily reduce the value of the creditor's stake--generating an 'externality' with respect to their creditors."); *see generally* Ronald H. Coase, *The Firm, the Market, and the Law* 24 (1990).

re Francis, 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998) (holding that Section 523(a) of the Bankruptcy Code "trumps any state release law . . . that might otherwise apply in favor of the debtor"); *Spicer*, 57 F.3d at 1156 ("whether or not" a settlement contains "an express release" providing that the debt is dischargeable, "a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress in § 523(a)(2)(A)").[18]

Indeed, this Court has suggested that issues of dischargeability should not be resolved outside the purview of the bankruptcy court, which would be required to approve any settlement reached during bankruptcy "after notice and a hearing." Fed. R. Bankr. P. 9019. Specifically, *Brown* noted that "[i]f a state court should expressly rule on § 17 questions, then giving finality to those rulings would undercut Congress' intention to commit § 17 issues to the jurisdiction of the bankruptcy court," rather than allow "prebankruptcy state-court adjudications." *Brown*, 442 U.S. at 135-36.

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In sum, this Court's decision in *Cohen* makes clear that a debt traceable to fraud is nondischargeable, and *Brown* holds that the fact that a stipulated judgment stands between the fraud and the debt does not prevent a bankruptcy court from inquiring into whether the debt is in fact traceable to the fraud. Nothing in the settlement agreement here purports to change this result, nor, as a matter of bankruptcy law, could it. Accordingly, the task of the bankruptcy court is clear—to allow a creditor a chance to prove that its debt is for money obtained by means of fraud, and therefore nondischargeable.

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18 The law of fraudulent conveyance would not provide sufficient protection against this risk, because a creditor may defeat a fraudulent conveyance challenge merely by showing that he personally received "approximately equivalent" or "roughly equivalent" value. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531, 538 n.4 (1994).

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted,

HARRY G. GORDON
GORDON LAW OFFICES
400 West Market Street
Greensboro, NC 27401
(336) 275-9910

SETH P. WAXMAN
Counsel of Record
PHILIP D. ANKER
CRAIG GOLDBLATT
ANNE HARKAVY
KATE HUTCHINS
WILMER, CUTLER & PICKERING
2445 M Street, N.W.
Washington, D.C. 20037
(202) 663-6000

Counsel for Petitioners

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